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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 Rate Regulation	MM Docket No. 93-215

COMMENTS OF
VIACOM INTERNATIONAL INC.

Richard E. Wiley
Philip V. Permut
Lawrence W. Secrest, III
William B. Baker

WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 429-7000

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Viacom International Inc. ("Viacom"), by its attorneys, hereby submits its comments on the Further Notice of Proposed Rulemaking[1] in this proceeding, which seeks to adopt a permanent cost-of-service regime under which cable operators can establish prices for regulated services.

I. INTRODUCTION AND EXECUTIVE SUMMARY

On March 30, 1994, the Commission adopted "interim" cost-of-service policies and rules to govern rate justifications by cable operators. The Commission in the same document also issued the FNPRM[2] which proposes to

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1 Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, FCC 94-39 (released Mar. 30, 1994)(Report and Order and Further Notice of Proposed Rulemaking)("Report and Order" and "FNPRM").

2 The FNPRM begins at paragraph 305 of the Report and Order and Further Notice of Proposed Rulemaking.

codify the current interim rules, with certain significant revisions, as its final set of cost-of-service rules.

Viacom, as both an owner of cable systems and a provider of cable program services,[3] has an obvious interest in Commission regulations that govern cost-of-service cable rate justifications. Viacom has consistently urged the Commission to promulgate cost-of-service regulations in a manner consistent with two core principles dictated by the Cable

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[3] Viacom is a diversified entertainment company. Viacom Cable, a division of Viacom, owns and operates cable systems serving approximately 1,100,000 subscribers. Showtime Networks Inc., a wholly-owned subsidiary of Viacom, owns the premium program services Showtime, The Movie Channel, and FLIX. Viacom's MTV Networks ("MTVN") division owns the advertiser-supported program services MTV: Music Television, VH-1/Video Hits One, and Nickelodeon (comprised of the Nickelodeon and Nick at Nite programming blocks). Viacom's wholly-owned subsidiary MTV Latino Inc. owns the advertiser-supported program service MTV Latino, which is distributed domestically and in Latin America. Viacom also owns Showtime Satellite Networks Inc., which licenses the SNI, MTVN and a variety of third-party program services to owners of home television receive-only earth stations nationwide. Viacom (either directly through its subsidiary Paramount Communications Inc. or through wholly-owned subsidiaries of its affiliates) also holds partnership interests in the advertiser-supported program services Comedy Central, USA Network, Sci-Fi Channel, and All News Channel, and in the regional sports networks Prime Sports Northwest and the MSG Network. In addition, Viacom is engaged in: television and radio broadcasting; the production and licensing of syndicated and network television programming and interactive media; the production, distribution and exhibition of theatrical motion pictures; the ownership and operation of professional sports franchises; the ownership and operation of amusement parks and arenas for live entertainment; the publication and distribution of educational, business and trade books; and the licensing and merchandising of trademarks.

Act.[4] First, cost-of-service regulation should advance the Congressional intent that regulated cable rates replicate those that would exist under competitive conditions.[5] Second, the cost-of-service regime should ensure that the transition from the previous unregulated environment does not impair the financial ability of cable operators to provide quality service at reasonable rates. For the reasons discussed below, the Commission's interim and proposed cost-of-service rules fall well short of these principles and Congressional intent.

Viacom respectfully submits that the Commission's cost-of-service rules should not further exacerbate the disincentives created by certain of the Commission's rate regulations which discourage cable operator investment in high quality programming and expansion of program diversity. Accordingly, the final cost-of-service rules should be revised so that cable operators may:

1. Include in their ratebases their "acquisition costs" except to the extent that they represent capitalized monopoly profits;

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[4] Cable Television Consumer Protection and Competition Act, Pub. L. No. 102-385, 106 Stat. 1460 (1992)("Cable Act of 1992" or "Cable Act").

[5] By "competitive," Viacom means rates that do not include any putative monopoly rents. This definition is also consistent with the Cable Act, which directs the Commission to regulate in a manner such that rates charged by systems not facing effective competition shall not exceed the rates that would be charged if the systems were subject to competition. See 47 U.S.C. § 543(b)(1) (Supp. IV 1992).

2. Include in their ratebases when upgrading their facilities the cost of plant capacity that will be used within 24 months; and

3. Earn a rate of return on their ratebases which is not predicated on that earned by telephone companies but rather is commensurate with the greater risk that cable systems face when compared with telephone companies, and earn a substantially greater markup on programming investments.

Finally, the Commission should not adopt a productivity factor which would lessen the return cable operators would receive on their capital investments.

II. THE COMMISSION'S COST-OF-SERVICE POLICIES SHOULD ESTABLISH RATES FOR REGULATED CABLE SERVICE THAT REPLICATE COMPETITIVE LEVELS

Viacom is very concerned that, out of a desire to ensure that cable operators do not earn in excess of a fair return, the Commission is proposing a regulatory scheme that will prevent operators from in fact earning even a fair return on their investments. To avoid this, the Commission needs to reverse its determinations (1) that a cable operator's ratebase be valued at historical costs; (2) that "goodwill" in its entirety be disallowed from a cable operator's ratebase; and (3) that only capacity that will go into service within 12 months be included in the ratebase. In combination, these determinations will have significantly deleterious effects on the ability of cable operators to earn a fair return on their investment and, in turn, on the public's ability to receive high quality service and programming at reasonable rates.

A. Cable Operators Should Be Allowed To Value Their Ratebase On The Basis Of Competitive Market Value, Not Historical Costs

The FNPRM proposes to require cable operators to value their assets at historical cost. In the case of a long-regulated industry, regulated entities would typically value assets at "historical" or "original" cost. This deters the regulatee from entering into transactions which will artificially inflate the cost of the asset and ensures that consumers will not pay more than is appropriate. The valuation established at any particular point in time usually is the cost of the asset at the time of its purchase and dedication to the public use, less depreciation or amortization.

The Commission's proposed rules would, however, apply this regime to a cable industry that was widely rate deregulated a decade ago. Viacom respectfully suggests that the application of this telephone-type regulation to the cable industry would disserve the public interest by frustrating the Congressional intent that cable rates be set at the same levels that would exist in a competitive environment.

As Viacom demonstrated in its initial cost-of-service comments, prices in competitive markets have little if anything to do with historical book values.[6] Indeed, net historical cost is particularly ill-suited for valuing ratebases for an industry as dynamic as the cable industry, where ongoing investment in and development of new technologies are the norm. Rather, the Commission should value a cable operator's ratebase at its competitive value -- that is, at a level that reflects market value less any putative monopoly rents.

The Kolbe/Vitka Study notes that a competitive market never values an asset at its historical cost. Rather, a competitive market takes into consideration inflation or disinflation, external factors such as technological changes and relative productivity during the years of operation, and the value of the opportunities that derive from a firm's presence in a rapidly expanding industry.[7] As historical

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[6] See Kolbe & Vitka, "RATE BASE ISSUES IN CABLE TELEVISION COST-OF-SERVICE REGULATION," attached to Comments of Viacom International Inc., MM Docket No. 93-215 at App. A (filed August 25, 1993) ("Kolbe/Vitka Study").

[7] Genuine competition, unlike the monopoly marketplace contemplated by traditional rate regulation, encourages firms to innovate and to improve service in order to grow and increase profits. As the Kolbe/Vitka Study explains, competition does this by offering firms above-normal profits in an expanding market where opportunities for new revenue streams are continuously being uncovered and below-normal profits in a shrinking market where such opportunities do not exist. See Kolbe/Vitka Study at 8-9.

costs are unaffected by any of these factors, by definition they cannot be used successfully to establish "competitive rates." For this reason alone, historical costs should not be the foundation of the Commission's cable regulation regime.

A further problem with the FNPRM's proposed use of net historical costs is that it proposes to value assets as of the time they were first acquired -- in other words, as if cable systems had always been subject to pervasive rate base regulation. This is simply not the case. It is settled law that the "original cost" of an asset is set by the value of the asset at the time it is first dedicated to public use.[8] The Report and Order erroneously asserts that cable systems have been regulated since the 1984 Cable Act and thus their assets have been "dedicated to the public use" since that time. The 1984 Cable Act and Commission regulations promulgated thereunder, however, generally deregulated cable prices to such an extent that one cannot reasonably contend that cable was, in the period from 1984 to 1992, subject to a pervasive regulatory scheme for purposes of rate regulation. In fact, the first time cable was so regulated was October 1992, the date of enactment of the Cable Act. Thus, even

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[8] See 47 C.F.R. § 32.9000 (1993); Rate Base and Net Income of Dominant Carriers, 7 FCC Rcd 296 n.3 (1991); American Tel. & Tel. Co. v. United States, 299 U.S. 232, 238 (1936).

under a regime based on historical costs, the Commission must allow operators to establish their ratebases using October 1992 values, not those of some earlier time.

Given the obvious problems with establishing proper historical costs and their inability to serve as a basis for "competitive" rates, Viacom respectfully urges the Commission to value cable assets at their "competitive" worth.[9] This will ensure that cable operators earn a fair return on their investment and that the public pays only reasonable rates.

B. The Allowed Intangibles In The Ratebase Should Include That Portion Of Goodwill That Does Not Consist Of Capitalized Monopoly Rents

The FNPRM recognizes that certain "intangible costs" legitimately can be included in a ratebase. It proposes, however, to give ratebase treatment only to those intangibles that it believes would have been incurred in competition -- organizational costs, franchise costs and customer lists. All others are presumptively disallowed from the ratebase.[10]

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[9] The Report and Order (¶ 92) improperly asserts that valuing the ratebase on the basis of acquisition costs would "require" customers to act as "guarantors" of the recovery of those costs. This misses the point. The real issue is the right of cable operators to pursue opportunities to earn a return on investments that were prudent when made. This is not an issue of "guarantees." The disallowance denies cable operators any opportunity to recover their investment, regardless of how attractive a product they may offer.

[10] Id. ¶¶ 84, 86 & 87.

In particular, the Commission proposes to disallow "goodwill." Viacom believes that the Commission's disallowance of goodwill is not in the public interest.

The proposed exclusion is based on the Commission's belief that prices paid for cable systems in the recent past often exceeded the book value of the purchased cable system's tangible assets due to expectations of "supra-competitive profits that the market power of cable systems operating in a less than fully competitive environment could expect to generate."[11] The record, however, simply does not support a presumption that expectations of monopoly profits were the exclusive, or even most likely, reason that cable systems were sold in the free market at excess of their net original costs.

For the reasons discussed in the preceding section, even in growing unregulated industries, where there are no incentives to inflate costs, competitive markets will value assets well above historical costs -- indeed, even well above replacement costs. This difference between competitive and historical costs, however, is not a result of manipulation or expectation of monopoly rents, but rather a recognition of the true perceived value of the assets involved. Given that this phenomenon exists in non-regulated environments, it is irrational to assume that the difference between the

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[11] Id. ¶ 91.

acquisition cost and the historical value of the assets in the cable industry represents solely, or even principally, the capitalization of monopoly rents.

Viacom acknowledges that it is impossible to establish as a fact that no portion of a cable system's purchase price reflects expectations of "monopoly rents." However, this does not justify the presumptive wholesale exclusion of goodwill from a system's ratebase. For this reason, Viacom has previously suggested that, as a safeguard, the Commission could disallow that portion of the "goodwill" account that reasonably could be expected to reflect "monopoly" expectations. To aid in this endeavor, Viacom submitted an analysis indicating that expectations of monopoly profits, while difficult to measure precisely, were unlikely to represent 10 percent of the preregulation market value of cable assets.[12] No party rebutted this analysis or submitted contrary evidence.

Accordingly, Viacom proposes that the Commission rely on, as indicative of a capitalization of monopoly rents, the Kolbe/Vitka Study as grounds for presumptively excluding 10 percent of acquisition costs, determined on the basis of fair market value of the assets. Certainly this would serve the public interest more than disallowing all such costs when it

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12 See Kolbe/Vitka Study at 2.

is obvious that at least a majority of the costs are legitimate and need to be recovered.

C. Operators Should Be Allowed to Include in the Ratebase Any Excess Capacity That Will Be Used Within a Twenty-Four Month Period

In the Report and Order, the Commission recognized that it is prudent for operators "to expand capacity beyond immediate needs, when such a present-day investment saves subscribers future costs for additional labor and equipment."[13] Consequently, the FNPRM proposes to allow operators to include excess capacity in the ratebase if that capacity will be used within a twelve-month period. The Commission did not propose to include the cost of capacity expected to be used over a longer period due to a fear that such a policy would encourage unnecessary capital expenditures and lead to unjustifiably higher rates.

While Viacom understands the Commission's fears, it respectfully suggests that the selection of a twelve-month period is unreasonably short and will undermine important objectives of the 1992 Cable Act. A prudent cable operator will always design the construction project to include a reasonable amount of excess capacity in order to meet expected but not yet current demand. This "efficiency," as

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13 Report and Order ¶ 116.

the Commission noted, yields direct subscriber benefits in lower costs and ultimately lower rates.

However, if a cable operator can include in the ratebase only that portion of the investment it will use within twelve months, it obviously will have an incentive to make a significantly smaller upgrade than would otherwise be prudent. An operator has little incentive to incur upfront costs that it cannot recover in its ratebase in a reasonable timeframe.[14] If the operator later engages in further construction in order to reach the same capacity that the prudent unregulated operator would have reached in a single upgrade, the total cost of the two upgrades would inevitably be more expensive and consumers will pay higher rates. And if the cable operator ignores this issue and nevertheless builds-in excess capacity, it is penalized for making such a decision. The public interest is not served by a regime such as this which penalizes sound economic decisions and consequently creates incentives for an operator not to proceed in cost-efficient ways.

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[14] In this situation, the operator likely could not begin to recover the costs of the capacity that will be used in months 13 through 24 until at least two years later. This is because the Commission has limited cable operators to only one cost-of-service case every two years. Thus, if a cable operator relies on a cost-of-service case now, and cannot include the costs of capacity that will be put in use 13 to 24 months from now, it will be at least two years before its rates will be able to recover those capacity costs.

Accordingly, Viacom urges the Commission to adopt permanent rules allowing inclusion in the ratebase of all capacity that will be used and useful within two years. This period more properly balances the private and public interests involved.

III. THE COMMISSION SHOULD AUTHORIZE A RATE OF RETURN GREATER THAN 11.25 PERCENT

The Commission's interim cost-of-service rules authorize an overall rate of return for cable operators of 11.25 percent. The FNPRM solicits comment on whether a "different permanent rate of return for regulated cable service, including the equipment basket," should be established.[15] Viacom submits that a higher rate of return -- in the upper range of 14 to 16 percent[16] -- is required under Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944), and its progeny because of the current financial characteristics of the cable industry, including the effect of the Commission's own rate regulations.

Under Hope Natural Gas, a regulatory agency must allow a return on equity "sufficient to assure confidence in the

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[15] FNPRM ¶ 305.

[16] Viacom's proposed rate of return on the ratebase should in no way be understood to serve as well as a recommended markup on programming expenses. As set forth infra, even a rate of return on the ratebase on the order suggested in these comments would be inappropriate and wholly inadequate as an incentive for programming investment.

financial integrity of the enterprise" so that its credit is maintained and it may continue to attract capital. Only five years ago the Supreme Court reaffirmed the principle that a just and reasonable rate depends "to some extent on what is a fair rate of return given the risks under a particular rate-setting system, and on the amount of capital upon which the investors are entitled to earn that return." Duquesne Light Co. v. Barasch, 488 U.S. 299, 310 (1989); see also Permian Basin Area Rate Cases, 390 U.S. 747, 792 (1968) (rates must be sufficient to "maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed").

Although Viacom disagrees with many of the steps used in the Commission's analysis, the fundamental problem with both the interim and the proposed rate of return of 11.25 percent is that it is unreasonable on its face and therefore fails the Hope Natural Gas/Duquesne Light test. An 11.25 percent rate of return on the ratebase and the equipment basket, the same as the Commission has set for the dominant local and interexchange carriers, can be found reasonable for the cable industry only if the cable industry and the telephone industry are the same in terms of "risk." Such an assumption, however, is unsupported by the record and unreasonable in view of the significant differences between the two industries. Cable operators face a much riskier operating environment than do telephone companies, and accordingly require a commensurately higher rate of return in order to attract capital.

As the Report and Order itself acknowledges, "the cable industry is a relatively new industry, characterized by growth and earnings reinvestment as well as a heavy reliance on private and semi-public sources of capital, and . . . cable investors' expectations may differ from those of other investors."[17] It is also relevant that cable system operators typically pay low dividends, carry high debt levels, and face substantial potential competition not only from over-the-air broadcast television, but also from direct broadcast satellite, SMATV, MMDS and telephone companies.

In contrast, local exchange companies and AT&T are among the largest and most financially sound corporations in the United States, have long provided service over mature systems, have well established and enduring monopolies, generate much of their capital internally, and pay relatively high dividends. The difference, in short, is the difference between riskier "growth" companies and stable "blue chips."

Nor does the 11.25 rate of return properly recognize the effects of the Commission's own cable rate regulation actions. Indeed, the FNPRM implicitly concedes as much when it requests comment on how the risks of regulated cable

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[17] Report and Order ¶ 158.

service "are affected by our cost-of-service and our benchmark/price cap rules for cable." It is clear that the Commission's recent regulatory actions have increased the cable industry's cost of capital and debt. Nothing else could result from the Commission's actions aimed at reducing cable prices by up to 17 percent. The inevitably reduced cash flow, in turn, increases what Duquesne Light called the "risks under a particular rate-setting system" of cable service and justifies a higher rate of return than the 11.25 percent that the Commission deemed reasonable (for the equipment basket) before the most recent order for further rate reductions.[18]

For these reasons, the Commission should apply a reasoned "risk premium" analysis that measures the risk facing cable investors directly. As demonstrated by a study prepared previously in this proceeding by the Brattle Group, this should result in adoption of a permanent authorized rate

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[18] One possible explanation for why the Commission's analysis reaches an unreasonable result is that the agency applied a discounted cash flow analysis to an improper surrogate. Neither the Report and Order nor the FNPRM adequately considers that the chosen surrogate -- the S&P 400 -- has significantly different characteristics from the cable industry. Cable companies, like most companies in a rapidly growing and changing industry, are materially more risky than the industries represented in the S&P 400, and therefore must offer equity investors a correspondingly greater expectation of returns. This is also evidenced by the significantly greater "betas" of stock prices of the cable industry than of the S&P 400 generally.

of return on the ratebase in the range of 14 to 16 percent.[19]

Furthermore, the Commission should ensure that its cost-of-service rules provide meaningful incentives for programming investment. Given the singular importance of programming to the public, programming costs should neither be treated as an ordinary expense nor marked up on the meager 7.5 percent prescribed by the Commission's current price cap rules. The Commission's cost-of-service rules should, indeed, afford programming costs a markup substantially greater than any enhanced rate of return of general applicability that the Commission adopts in this proceeding. Viacom's recent comments on benchmark/going-forward issues recommended that the Commission allow a markup on license fee increases equal to the average percentage margin embedded in an operator's permitted tier rate.[20] An analogous approach could well be applied in the context of a cost-of-service showing.

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[19] See Kolbe & Borucki, "RATE OF RETURN ISSUES IN CABLE TELEVISION COST-OF-SERVICE REGULATION," attached to Comments of Cablevision Industries Corporation, et al. MM Docket No. 93-215 (filed August 25, 1993).

[20] See Comments of Viacom International Inc., MM Docket No. 92-266 (filed June 29, 1994).

IV. A PRODUCTIVITY OFFSET IS NOT APPROPRIATE FOR THE CABLE INDUSTRY

The Commission should not adopt a productivity offset for cable rates for the same reasons that it has not adopted such an offset previously.[21] Circumstances have not changed sufficiently to justify adoption of the proposed offset of two percent.

As the Commission has itself observed, the GNP-PI price cap index itself inherently takes productivity into account because it "automatically reflects certain productivity gains in the economy."[22] Thus the issue becomes whether the Commission should create an additional offset to recognize productivity. Viacom submits that productivity offsets simply are not appropriate for use at this stage in the evolution of the cable industry.

First, productivity offsets are a regulatory tool intended to encourage operating efficiencies in mature, regulated monopoly utilities, such as local exchange telephone companies. The less mature stage of the cable

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[21] Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, 8 FCC Rcd 5631, 5781-82 (1993) (Report and Order and Further Notice of Proposed Rulemaking). In that decision, the Commission declined to adopt a productivity offset to the GNP-PI for the non-programming costs incurred by cable companies, noting the lack of an evidentiary basis.

[22] Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation, 74 Rad. Reg. 2d (P&F) 1247, 1263 (1993).

industry's development, the spur of potential competition from DBS and telephone companies, and the comparatively riskier financial condition of many cable companies all militate against the use of an offset in cable regulation.

Second, as the Commission has recognized previously, there is no credible evidentiary basis for measuring cable industry productivity. When the Commission adopted a productivity offset in the telephone area, it did so based upon, and only after, numerous studies that examined productivity in the telecommunications industry over periods of up to fifty years.[23] Corresponding data for the cable industry simply do not exist. Indeed, the tentative conclusion in the FNPRM that cable operators can be expected to achieve productivity gains analogous to those of other communications industries -- mentioning only the telephone industry -- rests upon sheer surmise.

Finally, the Commission should recognize that adoption of an inappropriate offset would pose a threat to long term investment in both cable infrastructure and programming that would far outweigh any conceivable benefit to consumers. The possible harm from such an offset would merely magnify the severe impact on cable financing already caused by the draconian 17 percent rate cut recently ordered by the

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[23] See Policy and Rules Concerning Rates for Dominant Carriers, 4 FCC Rcd 2873, 2977 (1989).

Commission. In sum, Viacom urges the Commission once again to act cautiously and refrain from imposing any additional offset.

V. CONCLUSION

For the foregoing reasons, Viacom International Inc. respectfully urges the Commission to adopt cost-of-service final rules that incorporate the modifications suggested herein.

Respectfully submitted,

VIACOM INTERNATIONAL INC.

By: William B. Baker

Richard E. Wiley
Philip V. Permut
Lawrence W. Secrest, III
William B. Baker

WILEY, REIN & FIELDING
1776 K Street, N.W.
Washington, D.C. 20006
(202) 429-7000

Its Attorneys

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